FitchRatings

Fitch Affirms Mexico at 'BBB'; Outlook Stable

Fitch Ratings - New York - 13 December 2019:

Fitch Ratings has affirmed Mexico's Long-Term Foreign-Currency Issuer Default Rating (IDR) at 'BBB' with a Stable Outlook.

A full list of rating actions follows at the end of this rating action commentary.

Key Rating Drivers

Mexico's ratings are supported by the country's diversified economy and a track record of a robust and disciplined policy framework that has anchored macroeconomic stability and contained imbalances. While some of the Lopez Obrador administration's microeconomic policy decisions have proved contentious, macro policy choices have been relatively orthodox to date. These strengths are counterbalanced by Mexico's rating constraints, which include economic growth below the 'BBB' median, a low fiscal revenue base compared with peers, shallow credit penetration, and governance scores among the lowest in the 'BBB' category.

Having experienced a technical recession in 1H 2019, the economy is stagnating and Fitch expects only a muted recovery to 1% growth in 2020. This is below Fitch's expectations at the last review and well below the 'BBB' median average growth rate and the agency's estimate of potential growth of 2.5%, which Mexico last attained in 2016. A fall in private investment (and a 20% drop in public investment year to date) has weighed on the economy in 2019, and appears to be driven more by domestic rather than external trade-related uncertainty; part of this reflects a pattern seen before in the first year of a new administration. Fitch estimates that investment contracted by around 4% in 2019, subtracting 0.8pp from overall GDP growth. Fitch expects a flat contribution from investment next year as investors come to terms with the changed environment under the administration of Lopez Obrador. There is potentially some upside from private investment in infrastructure projects starting in early 2020 as part of the government's development plan, and USMCA passage may encourage more FDI. Private consumption has flagged, with the pace of formal sector job creation having fallen in 2019, but there are signs that this is bottoming out and will improve in 2020.

Amid US trade tensions with China, Mexico's exports have held up well and some categories are gaining market share in the US, its main trading partner. However, year on year growth in monthly exports has slowed sharply during 2019 (developments in the US auto sector affected exports in recent months) and global trade tensions could continue to weigh on the outlook; an expected U.S.-China deal leaves existing tariffs largely in place. The recent signing of a revised USMCA trade deal, which should be followed by ratification in the US, Canada and Mexico by 1Q20, dispels trade uncertainty but does not significantly expand market access or strengthen Mexico's growth prospects, in Fitch's view. Even if the treaty is approved, trade tensions with the U.S. cannot be ruled out, especially if U.S. authorities again opt to link trade to other bilateral issues such as security, crime or migration. Mexico has reduced flows of migrants to the U.S., thereby avoiding the imposition of tariffs threatened in June.

Lower interest rates should provide some stimulus to the economy in 2020. The Banco de Mexico (Banxico) has embarked on a policy rate easing cycle, helped by the onset of Fed easing, cutting its policy rate by 75bp

through November to 7.5%. Fitch expects one further cut of 25bp in 2019 followed by a further 50bp in 2020. Headline inflation is 3%, but core inflation is 3.7%, higher than the 3% target. Banxico is mindful of the risk of external shocks that could lead to peso depreciation, capital outflows and increased inflationary pressure.

Maintaining a tight fiscal stance while the economy is stagnating represents a trade-off. The 2020 budget approved in November sticks largely to the budget framework inherited from the previous administration. The budget is consistent with fiscal rules, although the government invoked an escape clause in the case of the rule that mandates a balanced budget net of investment, which was missed by 0.1% of GDP. Fitch expects general government debt (a different measure from that used in the budget) to remain relatively stable at 43% of GDP in 2020 (compared to 36% of GDP for the current peer median).

The 2020 budget targets a 0.7% of GDP non-financial public sector (NFPS) primary surplus for the non-financial public sector (2019: 1.0% of GDP), equivalent to an overall NFPS deficit of 2.6% of GDP. Fitch believes the 2020 budget is too optimistic on oil revenues (although it still expects a fall relative to 2019) and the economic growth assumption. Revenues underperformed in 2019, led by a shortfall of 0.5% of GDP in oil revenues as production contracted, but also including non-oil revenues. The government expects to withdraw up to MXN150 billion from the budgetary revenue stabilization fund (FEIP) to make up the shortfall.

Given Fitch's view of the optimistic nature of the budget's revenue projections for 2020, we expect that the government will likely again draw on the FEIP in 2020 (use of the fund does not count against deficit targets set out in the fiscal rule), but this could leave the fund largely depleted by 2021. The government is considering tax reform ideas that could be applied from 2022 and a reform to the fiscal framework to allow more counter-cyclical policy. Fitch believes that it would be challenging to meet the current fiscal target in 2021 absent a tax reform, but the prospects for the latter could be complicated by congressional elections in 2021.

State-owned oil company Pemex will contribute less to federal revenues in 2020 than in 2019 (1.8% of GDP), as the government implements consecutive cuts in tax rates through 2021. Fitch also expects Pemex oil output to continue to fall in 2020, having fallen 9.6% year-on-year in 10M19, averaging 1.64mbd. This contrasts with the ambitious increase in output to 1.85mbd (1.95mbd when including fast-growing private sector output) in 2020 assumed in the budget which is based on the company's business plan.

Although the company is a net contributor to the federal government, its mostly USD-denominated debt of over 8% of GDP will continue to represent a contingent liability for the sovereign. The federal government injected a further USD5 billion into the company in September to support a buyback of shorter-dated debt and a liability management operation that reduces the company's near-term repayments and improves short-term liquidity.

Risks from external finances appear contained. The current account deficit has shrunk in 2019, partly driven by a sharp fall in imports as investment has contracted, and will remain moderate in 2020. The IMF renewed Mexico's precautionary Flexible Credit Line, to which Mexico gained access in 2009, but which it has not used, for another two years. It further cut the amount available to USD61 billion (from USD74 billion), equivalent to around one-third of reserves.

Sovereign Rating Model (SRM) and Qualitative Overlay (QO)

Fitch's proprietary SRM assigns Mexico a score equivalent to a rating of 'BBB' on the Long-Term Foreign Currency IDR scale.

Fitch's sovereign rating committee adjusted the output from the SRM to arrive at the final LT FC IDR by applying its QO, relative to rated peers, as follows:

--Macroeconomics: +1 notch, to reflect Mexico's track record under successive administrations of prudent, credible and consistent macroeconomic policies. The authorities continue to emphasize macroeconomic stability in their policy actions, which has contained macroeconomic imbalances.

--Public Finances: -1 notch, to reflect our expectation that ongoing sovereign support for Pemex will result in a lower tax take and/or higher general government debt burden, negatively impacting public finances.

Fitch's SRM is the agency's proprietary multiple regression rating model that employs 18 variables based on three-year centered averages, including one year of forecasts, to produce a score equivalent to a Long-Term Foreign Currency IDR. Fitch's QO is a forward-looking qualitative framework designed to allow for adjustment to the SRM output to assign the final rating, reflecting factors within Fitch's criteria that are not fully quantifiable and/or not fully reflected in the SRM.

RATING SENSITIVITIES

The main factors that individually, or collectively, could result in positive rating action include:

--Improved investment and growth prospects underpinned by credible macroeconomic policies;

-- Declining government debt burden and reduction in contingent liability risks related to Pemex;

--Improvement in governance indicators to a level closer to the rating category median.

Developments that could individually, or collectively, result in negative rating action include:

--A weakening in the consistency and credibility of the macroeconomic policy framework and/or sustained macroeconomic underperformance, for example through consistently weak growth;

--A trend increase in the government debt burden, evidenced by an upward trajectory in the general government debt ratio;

--Deterioration in governance indicators that widens the gap further to the scores of 'BBB' category peers.

Key Assumptions

Fitch assumes that the global economy performs in line with the Global Economic Outlook dated December 2019.

Fitch assumes that a revised USMCA recently agreed by Mexico, Canada and the US is ratified and enters force in 2020.

ESG Considerations

Mexico has an ESG relevance score of '5' for Political Stability and Rights as World Bank Governance Indicators have the highest weight in Fitch's SRM; these are therefore highly relevant to the rating and a key driver with a high weight.

Mexico has an ESG Relevance Score of 5 for Rule of Law, Institutional & Regulatory Quality and Control of Corruption as World Bank Governance Indicators have the highest weight in Fitch's SRM; this is highly relevant to the rating and a key rating driver with a high weight.

Mexico has an ESG Relevance Score of 4 for Human Rights and Political Freedoms as the Voice and Accountability pillar of World Bank Governance Indicators is relevant to the rating and a rating driver.

Mexico has an ESG Relevance Score of 4 for Creditor Rights as willingness to service and repay debt is relevant to the rating and a rating driver, as for all sovereigns.

RATING ACTIONS

ENTITY/DEBT	RATING	PRIOR
Mexico	LT IDR BBB ⊙ Affirmed	BBB ⊙
	ST IDR F2 Affirmed	F2
	LC LT IDR BBB ⊙ Affirmed	BBB ⊙
	LC ST IDR F2 Affirmed	F2
	Country Ceiling A- Affirmed	A-
senior unsecured	LT BBB Affirmed	BBB
senior unsecured	ST F2 Affirmed	F2

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Applicable Criteria

Sovereign Rating Criteria (pub. 26 May 2019)
Country Ceilings Criteria (pub. 05 Jul 2019)

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